Distressed M&A 2021

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Global overview

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M&A activity typically follows general economic cycles. One would thus have expected that the covid-19 pandemic would finally lead to a slowdown of M&A activity by putting an end to the bull market that had been observed more or less worldwide since 2010, after recovery from the financial crisis of 2008–2009. This expectation has proven to be only partially true. In fact, market analysis in various jurisdictions shows that while M&A activity in general has declined to some extent in most – but not all – regions during the first wave of the covid-19 pandemic in the first half of 2020, the expected wave of distressed M&A transactions has not been recorded yet. The most important reason for this is to be found in the massive aid programmes that were set up in numerous jurisdictions to support economic activities, often combined with a temporary relief to file for insolvency proceedings. But these aid programmes are finite, and with the ongoing pandemic distressed M&A transactions are expected to increase sharply in the near future, especially in hard-hit industries such as (air) transport, retail or leisure to name just the obvious. In addition to general economic cycles, problems in specific industries can also trigger an increase in distressed M&A activity. For example, the massive collapse in oil prices in 2014 led to a large number of insolvency proceedings in the oil industry in which companies or parts thereof received new owners. In the same industry, a further wave of insolvencies or distressed M&A deals is currently being discussed as many long-term debt financing programmes entered into after the price shock of 2014 will expire in the coming years and it is unclear whether such financing programmes can be refinanced if oil prices remain at levels considerably lower than when the financing programmes have been entered into. Similar problems have been observed in the past years in various industries with sector-specific issues, for example in the retail industry in connection with ever-increasing online trading, or in the automotive (supply) business with the fundamental change from carbon-based drives to electric or other alternative drives.

But what does 'distressed M&A' mean? There is no clear-cut definition of the term, but typically distressed M&A refers to the sale of assets, businesses or shares where the seller is in financial distress or where the company to be sold is itself in financial distress. A business is, therefore, not sold because it no longer fits the strategy of the seller or because the seller is trying to develop the business profitably, but because there is an immediate threat of liquidity problems or even insolvency. The spectrum of financial distress can range from initial discussions with lenders about future cash requirements to formal restructuring discussions before or after the opening of insolvency proceedings.

When looking at the differences between 'traditional' M&A activity and distressed M&A transactions from the distressed M&A lawyers' point of view, three elements are of particular importance. The first one is legal: Because distressed transactions are carried out when the target or its parent company already entered into restructuring or insolvency proceedings or where there is a more or less imminent risk of opening of such proceedings, restructuring and insolvency law issues always need to be considered in distressed M&A scenarios. Lawyers advising in the context of distressed M&A therefore not only need to know the rules of the game in traditional M&A but also need to have a sound understanding of restructuring and insolvency law. Quite a few practitioners see these wide-ranging legal challenges as welcome compensation for the often enormous time pressure and sometimes frustrating circumstances involved in distressed scenarios.

The second element has just been mentioned: time pressure! While traditional M&A transactions usually extend over several months, distressed transactions need to be completed in a much shorter time frame, typically ranging from a few weeks to just days in extreme circumstances. Time pressure is usually caused by the imminent insolvency of the distressed company or, if insolvency proceedings have already been opened, often by legislative requirements regarding the time available to complete a transaction. The limited time available means that various transaction steps must be carried out in parallel and sometimes in an extremely abbreviated form (eg, due diligence). This in turn leads to the fact that only some of the traditional risk minimisation mechanisms from traditional M&A transactions can be used and alternative mechanisms have to be implemented where possible.

The third significant element in distressed M&A deals is the number of stakeholders involved. Whereas a traditional M&A process is clearly guided by the (opposing) interests of seller and buyer, many more stakeholders play a more or less important role in distressed scenarios: employees and trade unions, insolvency administrators and other authorities, customers, suppliers and especially lenders who risk losing part of their injected funds due to the financial distress of the affected company. Very often these stakeholders have conflicting or even mutually exclusive interests. Where a (highly) leveraged company is in financial distress, the restructuring process is typically led by or under significant influence of lenders or lender groups, whose interests in turn very often conflict depending on the status of their debt as senior secured, senior or junior loan.

With regard to transactional issues and drafting of transaction documents, the specific provisions of the jurisdictions involved naturally play a central role (and often also a limiting role in cross-border distressed M&A transactions). From the buyer's perspective, the following elements are regularly important:

- Level of distress: A buyer will first try to get a clear picture of the financial situation of the target. Of great importance is, of course, the question whether the target or the seller is already in formal insolvency proceedings or not. Depending on this, the buyer will have more or less options to take influence on the structuring of a transaction. In this phase it is also important to understand the immediate financing needs of the company in distress. Finally, a buyer will also try to find out which interests other stakeholders are pursuing, for example, lenders who are trying to realise possible collateral.
- Due diligence: For various reasons, due diligence in a distressed scenario can practically never be performed as in a traditional M&A transaction. The first limiting element is the time frame. Often a due diligence has to be carried out and completed within a few days. This is partly aggravated by the fact that access to information is

difficult because management or the sellers have little interest in disclosing relevant information in the case of a forced sale. Buyers will therefore have to limit themselves to essential aspects at an early stage and try to obtain sufficiently reliable information on these essential points. An increasingly important element in this context is W&I insurance, which is also very common in distressed M&A transactions. However, W&I insurers usually insist on at least fundamental due diligence on those areas that should be covered by a W&I insurance policy. Buyers will accordingly insist that at least the essential information on these areas is disclosed.

- Transaction structure: While in traditional M&A transactions share deals represent the vast majority, asset deals have decisive advantages and are thus frequent in distressed scenarios. Asset deals have the particular advantage for the buyer that only certain assets are taken over ('cherry-picking') and undesirable (including unknown or contingent) liabilities do not have to be taken over (although caution is advised in this regard, as in certain jurisdictions liabilities are also taken over when a business unit is taken over in the form of an asset deal). Another decisive question for the buyer is whether the assets will be acquired before or after the opening of insolvency proceedings. A takeover before the opening of insolvency proceedings often involves the risk of legal challenges by creditors due to a transfer of assets at undervalue if the seller goes bankrupt after the sale. This regularly involves liability risks for the seller's acting bodies. A pre-packaged deal can eliminate or minimise these risks, but it also means that a transaction can only be carried out with the involvement of trustees or insolvency courts, which can involve new risks and problems. In practice, numerous varieties of structuring distressed transactions have developed (keywords include 'hive-down', 'debt-to-equity-swap', 'loan-to-own', 'stalking bidder', etc), which are described in more detail in the individual chapters of this publication.
- Warranties, indemnities and W&I insurance: When buying from a bankruptcy estate, buyers often receive little or no assurances from the seller and must try to take the corresponding risks into account in the price offered. In a purchase outside of insolvency proceedings, however, buyers try to negotiate warranties and indemnities with the seller and then cover them with W&I insurance. A prerequisite for obtaining insurance coverage is to regularly conduct an appropriate due diligence on the insured areas. Synthetic W&I insurance, where warranties are negotiated directly between the buyer and the insurer without the involvement of the seller, is slowly becoming more common, but here too the insurers are generally only willing to provide protection if an appropriate due diligence can be carried out.
- Pricing: Closing accounts and even earn-out agreements would in themselves be useful means of compensating for inaccuracies in pricing in a distressed situation, but in practice such agreements are rarely concluded, particularly because of the uncertainties about the continued existence of the seller. Fixed price deals are a clear priority in distressed transactions, possibly with an escrow solution for possible claims of the buyer against the seller for breach of warranties, depending on the situation.
- Regulatory approvals: In most jurisdictions, there are no general exceptions with regard to regulatory approvals (especially antitrust clearance and foreign investment controls) in distressed M&A deals. Nevertheless, in many jurisdictions the failing firm defence is recognised, which allows strategic investors to take over business activities from failing competitors under certain conditions, if such competitor would exit the market anyway. In some jurisdictions, the failing firm rules also allow a transaction to be completed before antitrust clearance is available. In distressed scenarios, this can be a decisive criterion for a transaction to be completed before the company has to be liquidated.

In this overview, we have so far largely pointed out 'problems' and risks for buyers, and the question arises as to why buyers want to take over assets or businesses at all in a distressed scenario. The answer is simple: price! Research has repeatedly shown that buyers of distressed businesses achieve higher returns than in traditional M&A transactions and accordingly there is a widespread willingness to invest in distressed assets. As long as the level of available capital remains at the current very high levels, sellers of distressed businesses should still be able to find buyers for their assets or business, but at a more or less large discount to the price that could be achieved in a non-distressed situation.

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